Petition

81-1083

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In the Supreme Court of the United States

OCTOBER TERM, 1981

UNITED STATES OF AMERICA,

Respondent,

vs.

SAM S. SARCINELLI,

Petitioner.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

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QUESTION PRESENTED FOR REVIEW

In a federal income tax evasion prosecution can the government prove the necessary element of a tax due and owing by means of a theory of proof which it concedes would be insufficient in an identical civil tax proceeding?

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In the
Supreme Court of the United States

OCTOBER TERM, 1981

NO. _____

UNITED STATES OF AMERICA,

Respondent.

vs.

SAM S. SARCINELLI,

Petitioner.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

I.

OPINION BELOW

The opinion of the United States Court of Appeals for the Seventh Circuit is not yet reported; *United States* v. *Sarcinelli*, Slip Op. 80-2638 (7 Cir. October 23, 1981). That opinion is filed with this Court as Appendix A.

II.

JURISDICTION

The order of the United States Court of Appeals for the Seventh Circuit was entered on October 23, 1981. On

November 6, 1981 a petition for rehearing was filed. The Seventh Circuit denied the petition for rehearing on November 17, 1981. This Court's jurisdiction is invoked under 28 U.S.C. §1254(1).

III.

STATUTES INVOLVED

26 U.S.C. §61:

Gross income defined.

(a) General definition.

Except as otherwise provided in this subtitle, gross income means all income from whatever source derived, including (but not limited to) the following items:

(1) Compensation for services, including fees, commissions, and similar items;

(2) Gross income derived from business;

(3) Gains derived from dealings in property;

(4) Interest;

(5) Rents;

(6) Royalties;

(7) Dividends;

(8) Alimony and separate maintenance payments;

(9) Annuities;

(10) Income from life insurance and endowment contracts;

(11) Pensions;

(12) Income from discharge of indebtedness;

(13) Distributive share of partnership gross income;

(14) Income in respect of a decedent; and

(15) Income from an interest in an estate or trust.
(b) Cross references.

For items specifically included in gross income, see part II (sec. 71 and following). For items specifically excluded from gross income, see part III (sec. 101 and following).

26 U.S.C. §7201:

Attempt to evade or defeat tax.

Any person who willfully attempts in any manner to evade or defeat any tax imposed by this title or the payment thereof shall, in addition to other penalties provided by law, be guilty of a felony and, upon conviction thereof, shall be fined not more than $10,000, or imprisoned not more than 5 years, or both, together with costs of prosecution.

IV.

STATEMENT OF THE CASE

Sam S. Sarcinelli operated a reciprocal insurance company, Metro Inter Insurance Exchange ("MIIE"), a management company which directed MIIE's affairs, Metro Management Company, and a finance company which financed premiums for policyholders of MIIE, Lawn Budget Premium Finance Company ("Lawn Budget"). In August, 1971, MIIE was dissolved and Metro Casualty Company ("Metro Casualty") a regular domestic stock insurance company, succeeded to its business. Both before and after the formation of Metro Casualty, Sarcinelli was a 50% partner in Metro Auto Insurance Agency ("Metro Auto").

Sarcinelli was charged with willfully attempting to evade and defeat his personal income taxes for the years 1971 and 1972 (26 U.S.C. §7201). In May, 1980, he was tried with a co-defendant, who was the bookkeeper for these insurance companies. That trial ended in a mistrial when

the jury was unable to agree on any verdicts. The case was re-tried in September, 1980, and the jury found Sarcinelli guilty on both counts, but acquitted the bookkeeper.

Under §7201 the government was obliged to prove that the taxpayer owed a tax and that he evaded the payment of it. The government's principal proof of a tax due and owing related to certain premiums paid into MIIE and later to its successor, Metro Casualty. Some of these premiums were deposited into Metro Auto, the partnership in which Sarcinelli was a 50% partner. Metro Auto, thereafter, used some of these premiums to pay Sarcinelli's personal expenses and investments. It was the government's theory that at the moment any of these funds were expended for the benefit of the taxpayer, they became taxable income to him under Section 61 of the Internal Revenue Code of 1954. That section is the general definition for "gross income", which it defines as "all income from whatever source derived . . ." 26 U.S.C. §61.

Among other defenses offered by the taxpayer, it was argued that the funds received by Metro Auto and used by it to pay the personal expenditures should properly be classified as "constructive dividends" from MIIE or Metro Casualty. Sarcinelli had a controlling interest and a capital investment of several hundred thousand dollars in each of these insurance entities.

The government's tax expert agreed that Sarcinelli's relationship with these insurance companies fit the description of a controlled corporation and a majority stockholder. He also agreed that the IRS would typically treat the payments Sarcinelli received from the insurance companies through Metro Auto as constructive dividends. The IRS Agent acknowledged that as constructive dividends, these monies would only be taxable income under certain, well

defined conditions. (1) Constructive dividends would only be taxable income if it was demonstrated that the companies from which the dividends were received had sufficient earnings and profits to pay dividends. (2) If they did not, the amounts received would first be treated as a nontaxable return of capital. (3) To the extent that the return of capital exceeded the taxpayer's basis in his capital investment, the payments would be treated as capital gains. (4) Capital gains would only result in taxable income if they exceeded long or short term capital losses available to the taxpayer, and there was considerable evidence that the taxpayer had substantial capital losses.

Having conceded that these transactions would ordinarily be treated as constructive dividends and would result in taxable income only under the specific rules described above, the government's tax expert stated that the IRS would only apply these rules "in a civil situation". Because this was a criminal case, he said "there would be a different computation as to tax liability under civil proceedings as opposed to these (criminal) proceedings". This expert testimony formed the basis for proving taxable income in the prosecution.

The defendant moved for judgment of acquittal after the close of the government's case, but the trial judge promptly denied it. The defendant tendered an instruction advising the jury that they could determine that these payments were constructive dividends and informing them of the tax rules which would apply if they did, but the instruction was refused.

V.

A. THIS COURT SHOULD SET FORTH GUIDELINES ON INSTRUCTIONS AND BURDENS OF PROOF FOR CRIMINAL TAX PROSECUTIONS INVOLVING DISTRIBUTIONS TO SHAREHOLDERS FROM CONTROLLED CORPORATIONS.

The government has adopted a test for determining "tax due and owing" for criminal prosecutions which is in *direct* conflict with the tests developed by the courts and Internal Revenue Service for determining civil liability. The anomolous result is that the government's burden of proof is less in a criminal proceeding than in a civil proceeding when the exact same element is to be proved.

The defendant was charged with tax evasion under Section 7201 of Title 26 U.S.C. One of the essential elements of a Section 7201 charge is that there is proof that the defendant actually had a tax due and owing for the year in question. *United States* v. *Coppola*, 425 F.2d 660 (2d Cir. 1969)

In determining the tax consequences of funds diverted from controlled corporations, the Internal Revenue Service developed the concept of "constructive" or "preferential" dividends. Simply stated, they construed covert distributions to controlling parties as dividends and taxable to the individual in that fashion.

The courts have long sanctioned this procedure and consistent with the theory used the dividend sections of the Internal Revenue Code to determine the nature and taxability of the distributions. In essence, Section 301 of the Code provides that distributions styled as dividends are ordinary income to the recipient to the extent the corpora-

tion had earnings and profits. To the extent that the corporation did not have earnings and profits, the distribution was treated as a return of capital and thus *not* taxable. If the distribution exceeded the amount of invested capital, it was then treated as capital gain.

The case of *Bender* v. *United States*, P-H Memo 57-121, affd. 256 F.2d 771 (7th Cir. 1958) is illustrative of the long standing and traditional approach. The Tax Court case involved the assessment of a civil fraud penalty against the controlling shareholders of a cab company for income resulting from the use of funds diverted from the company. The court held, however, "the amount of withdrawals . . . diverted to personal use constituted ordinary income to petitioners only to the extent that Checker had earnings and profits for the years in which sums were withdrawn for personal use . . ." Since the civil tax penalty was at issue in *Bender* the court was well aware that a computation based on the principles of constructive dividends could result in a determination of no tax due and owing by the individuals and stated ". . . it may be that for some year there will be no deficiency. If so, the 50 per cent addition under Section 293(b) falls."

The theory was also routinely applied in *Olive E. Qualley, et al*, Paragraph 76,208 P-H Memo TC where the court stated "Where controlling shareholders divert corporate income to themselves, it is proper to regard such diverted funds as constructive dividends for tax purposes. *Jack M. Chesbro*, 21 TC 123 (1953), affd., 225 F.2d 674 [47 AFTR 1923] (2nd Cir. 1955); *Currier* v. *United States*, 166 F.2d 346 [36 AFTR 775] (1st Cir. 1948); *Dawkins* v. *Commissioner*, 238 F.2d 174 [50 AFTR 682] (8th Cir. 1956)."

In spite of the long settled law on the question the government's expert testified that a different test was to be

used in determining whether there was a tax due and owing in criminal cases. The government's expert clearly framed the issue:

"Q. So if we are to apply the rather classic theory of the government that monies obtained by a shareholder from his controlled corporation are constructive dividends, we cannot determine at this point (because Cohen could not determine whether there were earnings and profits to pay dividends) whether there is any income attributable to Mr. Sarcinelli, can we?

A. Yes, we can.

Q. Didn't we say that it can only be income to the extent of earnings and profits?

A. Yes, but that is in a civil situation.

Q. Well, we are talking about determining civil liability, are we not?

A. No, not here, sir.

Q. Well, aren't you there testifying as to what the tax liability of Mr. Sarcinelli would be? Isn't that one of your functions?

A. That is correct.

Q. And, that is, the civil tax liability?

A. No, sir.

Q. Well, aren't you here to help us, assist us, in determining whether one of the elements of the Government's charge is fulfilled, that is, in fact, there is a tax due and owing?

A. Yes, sir.

Q. So then your testimony does go to whether there is a civil tax liability?

A. No, sir.

THE COURT: Can you explain that?

THE WITNESS: That there would be a different computation as to tax liability under civil proceedings as opposed to these proceedings, sir.

THE COURT: Well, the specific question is whether this matter of there being earnings or surplus; is that any different in a civil case than it is in a criminal case?

THE WITNESS: Yes, it is, sir.
THE COURT: What is the difference?
THE WITNESS: The difference is there have been prior cases which indicate that there is diverted funds, earnings and profits will not be taken into consideration in the computation of taxable income.
THE COURT: Well would that be any different in a criminal case than in a civil case?
THE WITNESS: Yes, it would, sir, in accordance with prior cases." (Tr. 866-68)

It is apparent from the expert's testimony that he was relying upon *United States* v. *Miller*, 545 F.2d 1204 (9th Cir. 1976), cert. denied, 430 U.S. 930 (1977). *Miller* is illustrative of the disturbing trend of the courts to ignore the established law for determination of tax due. In *Miller* the court held that the constructive dividend rules did not apply in a criminal prosecution while tacitly acknowledging that they would be applicable in the civil case. Effectively, the government has reversed the burden of proof with respect to the proof of an essential element of the offense of tax evasion.

The last time the government sought to change the theory of proving a tax due and owing in a criminal prosecution was in *Holland* v. *United States*, 348 U.S. 121 (1954). The Supreme Court took certiorari in *Holland* to set forth the essential elements and guidelines of instructions on the "net worth method" of proving taxable income. The instant case fairly represents a new trend in prosecution tax theory—a mere receipt of money by the taxpayer from his corporation is income unless the defendant proves otherwise. We believe this Court should again take certiorari to set forth the necessary guidelines of instructions and prosecutorial burden of proof.

CONCLUSION

For the foregoing reasons, this Court should grant certiorari.

Respectfully submitted,

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APPENDIX

APPENDIX

APPENDIX A

UNITED STATES COURT OF APPEALS
For the Seventh Circuit
Chicago, Illinois 60604

(Argued May 29, 1981)

October 23, 1981.

Before
Hon. Walter J. Cummings, Circuit Judge
Hon. William J. Bauer, Circuit Judge
Hon. Daniel H. Thomas, Senior District Judge*

UNITED STATES OF AMERICA,

Plaintiff-Appellee,

No. 80-2638 vs.

SAM S. SARCINELLI,

Defendant-Appellant.

Appeal from the United States District Court for the Northern District of Illinois, Eastern Division

No. 79 CR 575-1

John F. Grady, Judge.

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* The Honorable Daniel H. Thomas, United States Senior District Judge for the Southern District of Alabama, is sitting by designation.

ORDER

This case comes before this Court on the appeal of Defendant-Appellant Sam Sarcinelli who was convicted of wilfully attempting to evade and defeat his personal income taxes for 1971 and 1972, in violation of 26 U. S. C. §7201.

Sarcinelli contends that the trial court erred: (1) in refusing to give a theory of defense instruction that the defendant taxpayer relied on the advice of his accountant; (2) that the Government proceeded on the theory of proving the element of tax due and owing which would not be applicable in a civil proceeding; (3) the failure to give an instruction on constructive dividend theory; (4) that the indictment should have been dismissed as violative of double jeopardy where in the initial trial, the prosecutor in his final argument commented upon the defendant's failure to testify; and, (5) that the Government expert premised on his own conclusions on what are business and personal expenditures without any supporting evidence.

Having read the briefs, addressed itself to the record and heard arguments of counsel, we find no merit in Defendant-Appellant's claims, and we AFFIRM the judgment of the district court for the following reasons:

I.

Sarcinelli alleges that the district court erred in failing to instruct the jury as to the theory of defense that he in good faith relied on the advice of a competent tax expert. The Defendant "cannot shift the responsibility for . . . deficiencies to the accountants who prepared his returns if the taxpayer withholds vital information from his accountants. . . ." *United States* v. *Lisowski*, 504 F.2d 1268, 1272 (7th Cir. 1974). The evidence in this case is uncontro-

verted that Sarcinelli did not disclose all relevant information to his accountant. The district court was not in error in failing to give the requested instruction because where there is no evidence which reasonably supports that after full disclosure the taxpayer relied on the advice of the competent tax expert, there is no need to give a reliance instruction. *United States* v. *Hoopes*, 545 F.2d 721 (10th Cir. 1976), *cert. denied*, 431 U.S. 954 (1977).

II.

Sarcinelli further contends that the district court erred in two ways in permitting the government to prove a "tax due and owing" by applying a lower standard of proof for the determination of a tax liability in criminal cases and by failing to give a jury instruction on the Constructive Dividend theory. The evidence in this case, to the contrary, supports a finding that the Government established the receipt by the defendant of unreported taxable income and an additional tax due and owing. The burden was on the defendant to explain the receipts if they are not reportable income. *United States* v. *Lacob*, 416 F.2d 756 (7th Cir. 1969), cert. denied, 396 U.S. 1059 (1970). Further, there is no evidence which would allow a jury to conclude that there had been a corporate distribution which was non-taxable and, hence, there was no need for an instruction on corporate distribution. These claims of error made by the defendants are without merit.

III.

Counsel for Sarcinelli did not argue the fourth claim of error at oral argument, but in his brief argues that the Double Jeopardy clause was a bar to the second trial. In the first trial the judge declared a mistrial when the jury

was unable to reach a verdict. Defendant asserts that the hung jury was caused by the prosecutor's intentional, improper comment upon the defendant's failure to testify and concludes that a retrial was barred by the Double Jeopardy Clause. We find the contentions of the defendant without merit in that we conclude there was no prejudicial error in the prosecutor's final argument.

IV.

Sarcinelli in his final contention of error alleges that the Government expert premised on his own conclusions on what are business and personal expenditures without any supporting evidence. Although counsel for Defendant did not argue this claim of error at oral argument, his brief satisfactorily addresses this contention. The evidence at trial established that corporate funds were used to pay the operating expenses of two airplanes used on numerous occasions by the Defendant. We find that there was no prejudicial error in submitting the evidence to the jury for its resolution.

For each of the aforementioned reasons, we AFFIRM the judgment of the district court.

APPENDIX B

UNITED STATES COURT OF APPEALS
For the Seventh Circuit
Chicago, Illinois 60604
November 17, 1981.
Before
Hon. Walter J. Cummings, Circuit Judge
Hon. William J. Bauer, Circuit Judge
Hon. Daniel H. Thomas, Senior District Judge*

UNITED STATES OF AMERICA,

Plaintiff-Appellee,

No. 80-2638 vs.

SAM S. SARCINELLI,

Defendant-Appellant.

Appeal from the United States District Court for the Northern District of Illinois, Eastern Division.
No. 79 CR 575-1
John F. Grady, Judge.

ORDER

On consideration of the petition for rehearing filed in the above-entitled cause by defendant-appellant Sam S. Sarcinelli, all of the judges on the original panel having voted to deny the same,

IT IS HEREBY ORDERED that the aforesaid petition for rehearing be, and the same is hereby, DENIED.

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* The Honorable Daniel H. Thomas, United States Senior District Judge for the Southern District of Alabama, is sitting by designation.